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Agenda Item 7a

November 14, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** Corporate Governance Program
- II. **PROGRAM:** Total Fund
- III. **RECOMMENDATION:** Information
- IV. **ANALYSIS:**

This agenda item provides the first in a new quarterly update of the Corporate Governance Program. Updates for this quarter include:

- 1. Focus List Program Analysis
- 2. Proxy Voting Quarterly Report Results
- 3. Principles for Responsible Investment (PRI) Annual Update
- 4. Financial Market Reform Update
- 5. Policy Update

The following documents are attached:

- 1. Wilshire Focus List Program Analysis
- 2. Quarterly Proxy Voting Highlights
- 3a. PRI Report on Progress 2011
- 3b. Guidance on Responsible Business in Conflict-Affected and High-Risk Areas

Background

CalPERS Corporate Governance Program (Governance Program) functions to support the achievement of long-term risk-adjusted investment returns, consistent with the System's fiduciary duty. The program is structured into four work streams designed to implement CalPERS financial market reform, corporate engagement, integration of sustainability factors, and policy development including proxy voting initiatives.

In September 2011, the Governance Program was transitioned from Global Equity into an INVO-wide role that will support the total fund. This transition recognizes INVO's ongoing effort to integrate sustainability factors into investment decision making across asset classes. To support this transition, the Governance Program is moving toward an Investment Committee reporting model that provides a quarterly update on governance activities.

1. Focus List Program Analysis

Wilshire Associates (Wilshire) annually conducts an analysis to assess the financial performance of companies engaged through the Focus List Program (FLP). Historically, Wilshire measured only the results of FLP companies which were named to a public "name and shame" list. These companies were a sub-group of all engaged companies and generally made up less than half of the total companies engaged through the FLP in a given year.

At its November 2010 meeting, the Investment Committee approved staff's recommendations to enhance the FLP methodology including a change that all future FLP engagements would remain confidential. In place of public naming, CalPERS would file proposals seeking governance reform.

In Attachment 1, Wilshire measures the performance results of all companies publically and privately engaged from 1999 to 2009. The study found that over the last eleven years, privately engaged companies significantly outperformed those companies named to the public Focus List for the one, three, and five years after CalPERS made initial contact. All companies engaged through the FLP produced a total cumulative excess return of 11.59% above their respective benchmark after three years, and 4.77% after five years.

2. Proxy Voting Quarterly Report Results

Historically, staff has provided a separate quarterly proxy voting report in the Board's supplemental reporting document. Going forward, staff will incorporate this proxy voting report into this quarterly Governance Program update.

CalPERS Statement of Investment Policy for Global Proxy Voting (April 21, 2008) states that proxy voting rights must be diligently exercised as part of fiduciary duty. Staff executes all proxies and voting instructions in a manner consistent with this policy. As part of its voting responsibilities, staff reviews and analyzes information provided by companies, market experts, like-minded investors, proxy advisory firms, and the results of company engagements to ensure the votes cast are consistent with CalPERS Global Principles of Accountable Corporate Governance.

Attachment 2 provides a summary report that highlights CalPERS proxy voting decisions for the quarter of July 1, 2011 to September 30, 2011. CalPERS votes over 10,000 proxies in approximately 47 markets around the world on an annual basis. For the quarter, CalPERS successfully voted 1,226 company proxies consisting of 9,486 resolutions. The summary report provides a sample selection of domestic and international company resolution vote decisions including those tied to executive compensation and mergers and acquisitions.

One notable vote decision is related to a shareowner proposal CalPERS filed at Smithfield Foods, Inc. regarding declassification of the board. CalPERS proposal received 78% of the FOR vote cast. The company has since agreed to adopt a declassified board structure – annual election for all directors.

3. Principles for Responsible Investment Annual Update

Historically, staff provided the Investment Committee with a separate annual agenda item to give an update on CalPERS implementation of the United Nations-sponsored Principles for Responsible Investment (PRI). Going forward, staff will include its PRI update as part of a Corporate Governance Program quarterly update.

PRI is a network of international investors working to put six Principles for Responsible Investment (Principles) into practice. Table 1 displays each of the six Principles. CalPERS helped develop and became a founding signatory to PRI in 2006. The Principles reflect the view that environmental, social and governance (ESG) issues can affect the performance of investment portfolios.

Table 1

Principles for Responsible Investment
Principle 1 – Incorporate ESG issues into investment analysis and decision-making processes.
Principle 2 – Be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3 – Seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4 – Promote acceptance and implementation of the Principles within the investment industry.
Principle 5 – Work together to enhance effectiveness in implementing the Principles.
Principle 6 – Report on our activities and progress towards implementing the Principles

CalPERS is an active participant and leader in implementing the six Principles. Staff participates in a number of PRI associated activities including working groups, use of the PRI Clearinghouse, and PRI forum participation. In 2011, CalPERS board member Priya Mathur was elected to the PRI Advisory Council by asset owner signatories.

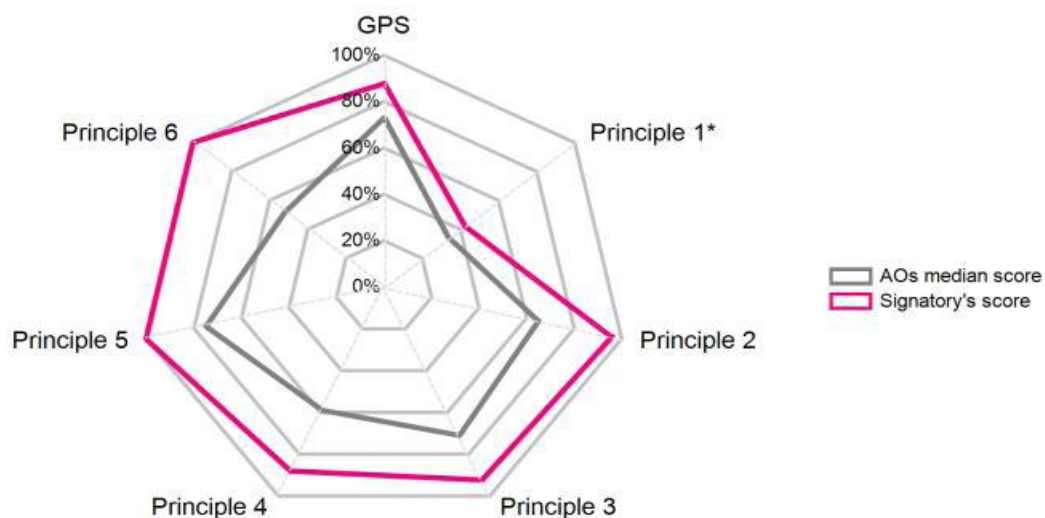
CalPERS Individual Progress 2011

CalPERS received feedback from PRI in September 2011 on its individual progress as an asset owner in implementing each of the Principles. In 2011, CalPERS:

- Improved its PRI assessment when compared to 2010.
- Maintained its top quartile ranking (compared to 2010) for Principles 2, 3, 5, and 6.
- Advanced its ranking from Quartile 2 in 2010 to Quartile 1 in 2011 for Principle 4.
- Maintained its Quartile 2 ranking in 2011 for Principle 1.

Improving CalPERS ranking for Principle 1 will be a measureable outcome of our total fund ESG integration initiative in 2012. The following diagram describes CalPERS 2011 performance against all PRI asset owners.

CalPERS 2011 Performance Against PRI Asset Owners



PRI Report on Progress 2011

Each year, PRI issues its Report on Progress (Attachment 3a) to present the findings from an annual survey on how investor signatories implement the Principles. Reflecting signatory feedback, growing demands for transparency and the need for robust reporting, PRI is developing a new reporting framework. The main objective is to reflect the growing diversity among members of PRI and to allow signatories to report more precisely on their responsible investment activities.

CalPERS is currently working with other PRI asset owner signatories to provide feedback on the new reporting framework. This will be piloted with signatories on a voluntary basis in 2012 and will be rolled out in 2013.

Priya Mathur Elected to PRI Advisory Council

PRI has a new advisory body, the Principles for Responsible Investment Advisory Council (PRIAC.) In August 2011, it was announced that CalPERS Board Member Priya Mathur will join the 16-member Advisory Council. Ms. Mathur was elected by PRI asset-owner signatories and joins eight asset-owner elected officials from global pension funds. Staff attended the September PRIAC meeting on behalf of CalPERS as a delegate for Ms. Mathur.

PRI Expert Working Group – Guidance on Responsible Business in Conflict-Affected and High-Risk Areas

CalPERS has taken a leadership role over the last two years on a multi-stakeholder working group (Expert Group) comprised of PRI signatory, Global Compact, and stakeholder participants to develop guidance to assist companies in implementing responsible business practices in difficult operating environments. In 2010, the working group launched Attachment 3b: Guidance on Responsible Business in Conflict-Affected and High-Risk Areas (Guidance.)

Currently, CalPERS is collaborating with a number of investors including APG, PGGM, TIAA-Cref, New Zealand Superannuation Fund, British Columbia Investment Management, and Robeco on a pilot program designed to test the operational relevance of the Guidance points across investor engagement activities.

2011 PRI Annual Event

Staff participated in the PRI Annual Meeting, September 15 – 16, 2011. The meeting provides an opportunity for PRI signatories to meet, learn and share experiences around PRI implementation and responsible investment. Sessions

are led by signatories and expert speakers with the emphasis on practical discussions designed for those implementing the Principles. This year's sessions included active ownership and integration of ESG analysis in listed equities, responsible investing in emerging markets, and passive investing and sustainable equity exchange-traded funds.

Staff contributed to working sessions on universal ownership and the role of human capital in ESG. In addition, staff joined a panel discussion entitled "Getting down to business on human rights: Standards, challenges and opportunities," which looked at recent proliferation of standards on business and human rights that investors could choose from as resources for their use and engagement activities and discussed what works, what does not and in which contexts.

4. Financial Market Reform Update

Proxy Access

In 2010, the U.S. Securities & Exchange Commission (SEC) adopted a new proxy access rule allowing shareowners who have held at least 3 percent of a company's shares for 3 years to require the company to include on its proxy card a nominee to the board of directors.

The SEC was challenged in court by the Business Roundtable and U.S. Chamber of Commerce which led to the rule being invalidated. In September, CalPERS co-ordinated leaders from some of the world's largest pension funds and institutional investors representing more than \$2 trillion in urging the SEC to issue a new market-wide rule on proxy access. SEC Chairman Mary Schapiro has since issued a public statement indicating her commitment to finding a way to make it easier for shareowners to nominate candidates to corporate boards.

U.S. Senate Banking Committee Testimony

Staff testified before the Senate Banking Committee on behalf of CalPERS to share views on a number of important investor protections included in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Staff's testimony focused on how inadequate corporate governance contributed to the 2008 financial crisis; and, how key governance provisions of Dodd-Frank are beneficial to investors in terms of improving the accountability of boards and enhancing investor protection. These key provisions included the value of proxy access, shareowner votes on executive compensation, improved disclosure, compensation "clawbacks", and issues such as derivatives reform.

Derivatives Regulation

Staff has been working closely with a group of public pension funds to develop solutions to certain provisions within the proposed U.S. Commodity Futures Trading Commission (CFTC) and SEC rules on business conduct standards. Discussions with regulators have been productive and staff continues to evolve the derivatives proposals in close consultation with fellow funds.

International Financial Reporting Standards (IFRS)

CalPERS provided comments on the SEC work plan for the consideration of incorporating IFRS into the financial reporting system for U.S. issuers; and, participated in an SEC roundtable on IFRS standards. CalPERS supports convergence to a single set of high-quality, international accounting standards and commends the SEC for its leadership efforts to consider whether and how IFRS will be incorporated into the financial reporting system for U.S. issuers.

Public Company Accounting Oversight Board (PCAOB)

The integrity of financial statements is a priority for CalPERS because financial reporting should provide users the information needed to make informed capital allocation decisions. Over the last quarter, staff participated in both roundtable forums and through direct comment to concept releases put forth by the PCAOB. The emphasis of CalPERS participation is to support the PCAOB in making substantive, robust changes that will improve auditor reporting and provide real value to investors and other users of financial reporting.

Governance Forums

CalPERS continued to contribute to governance reform through active participation in governance forums. Board members and staff have attended and taken speaking roles at the Council of Institutional Investors, International Corporate Governance Network, Ceres, Asian Corporate Governance Association, and Conference Board forums.

5. Policy Update

Revisions to CalPERS Global Principles of Accountable Corporate Governance have been proposed through the Policy Subcommittee to the Investment Committee. The proposed revisions include new and updated sections on board talent assessment and diversity, executive compensation, integrity of financial reporting, risk oversight, and disclosure and oversight of charitable and political contributions.

V. RISKS

Risk is related to the breadth of governance activities CalPERS could engage in through its Governance Program. The potential impact of not staying focused is the loss of effectiveness or timeliness in responding to governance priorities that directly affect CalPERS ability to advocate for investor protections or achieve sustainable, risk-adjusted returns.

VI. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII
- . Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VII. RESULTS/COSTS:

Costs are included in existing budget.

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